IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re KEYSTONE FARMS LP, Debtor.	No. 00-22568 Chapter 7
UNITED STATES OF AMERICA, Plaintiff, vs. KEYSTONE FARMS, L.P., THE REALTY SHOP, INC., ED H. STREET, JR. and ADAM EPSTEIN, Defendants.	Adv. Pro. No. 01-2011

M E M O R A N D U M

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

In this adversary proceeding, the United States on behalf of the Secretary of Housing and Urban Development ("HUD") seeks damages arising out of the defendants' alleged unauthorized diversion of funds from Keystone Farms Apartments, a federally assisted multi-family housing project, in violation of the debtor's regulatory agreement with HUD. The debtor and The Realty Shop, Inc. have counterclaimed, alleging that HUD breached the regulatory agreement and certain loan documents executed therewith, including the implied duty of good faith and fair dealing, and that such actions constitute economic duress. Presently before the court is the United States' motion to dismiss the counterclaim on the grounds that the court is without subject matter jurisdiction to the extent the counterclaim seeks recovery for a tort, i.e., economic duress; that the allegations regarding good faith and fair dealing fail to state a claim; and that the counterclaim is barred by sovereign immunity. For the reasons set forth below, the court

concludes that sovereign immunity precludes affirmative recovery by The Realty Shop on the counterclaim. In all other respects, the motion to dismiss will be denied. Although these matters are non-core proceedings, they are related to the underlying bankruptcy case and the parties have consented to the court's determination thereof and entry of appropriate orders and judgments in accordance with 28 U.S.C. § 157(c)(2).

I.

The debtor, Keystone Farms LP, filed for bankruptcy relief under chapter 11 on September 25, 2000.[1] In its amended complaint filed June 18, 2001, the United States alleges that the debtor is a Tennessee limited partnership and owner of Keystone Farms Apartments, a 90-unit federally assisted multi-family housing project (the "Project") located in Nashville, Tennessee. The managing general partner of the debtor, The Realty Shop, Inc, a Tennessee corporation, is also named as a defendant as well as Ed H. Street, Jr., the president of The Realty Shop, and Adam Epstein, The Realty Shop's vice-president. According to the amended complaint, the debtor obtained a loan in 1996 for the purpose of constructing the Project, which loan

[1]By agreed order entered August 30, 2001, the case was converted to chapter 7.

was insured against default by HUD. When the debtor failed to make a loan payment due April 1, 1999, HUD paid off the loan and was assigned the deed of trust on the Project such that HUD is now the debtor's principal secured lender.

The United States alleges in the amended complaint that in consideration of HUD's agreement to insure the loan, the debtor executed a regulatory agreement with HUD, which agreement under 12 U.S.C. § 1715l imposes certain regulations and restrictions on a borrower whose loan has been insured by HUD. The United States alleges that in violation of the regulatory agreement, the defendants made unauthorized withdrawals totaling $160,000 from Project assets between May 1 and August 31, 1999, and "additional unauthorized distributions of project funds, in unknown amounts" between December 8, 1999, and September 25, 2000, when the debtor filed for chapter 11 relief. The United States contends that it is entitled to recover double the value of Project assets wrongfully used from any owner of the Project "including the holder of 25% or more of the stock of an ownership corporation, any officer, director or partner of an ownership entity, and any agent of any owner," citing 12 U.S.C. § 1715z-4a.

In their answer, the defendants deny that any withdrawals were unauthorized distributions and state that the funds were

utilized for no purpose other than the payment of Project operating expenses, repairs and construction costs. In the counterclaim, the debtor and The Realty Shop as counterplaintiffs seek "civil damages arising out of the breach of the regulatory agreement by HUD and economic duress caused by HUD's actions in refusing to accept payment and in refusing to allow the loan in question to proceed to final endorsement." More specifically, the counterplaintiffs allege that "HUD has breached the regulatory agreement in failing to properly inspect the project as required, in disbursing funds without the approval of the counter plaintiffs, in failing to allow the project to go to final endorsement, in failing to call the letter of credit of the contractor when it was determined that the counter plaintiffs had incurred liquidated damages, and in failing to properly perform their duties under the regulatory agreement and loan documents." The counterplaintiffs allege that HUD's actions "are in breach of the loan documents and regulatory agreement" and that "said breach is the cause of the counter plaintiffs' damages." The counterplaintiffs further allege that "HUD's actions constitute economic duress and a breach of good faith and fair dealing presumed in all contracts, said economic duress being the direct and proximate cause of the counter plaintiffs' injuries."

In response to the counterclaim, the United States filed on June 15, 2001, the motion to dismiss which is presently before the court. The United States contends that to the extent the counterclaim sounds in tort, "it should be dismissed for failing to meet the administrative filing requirements of the Federal Tort Claims Act." The government cites 28 U.S.C. § 2675(a) which provides that an action against the United States for money damages caused by the "negligent or wrongful act or omission of any employee of the Government" may not be maintained "unless the claimant shall have first presented the claim to the appropriate Federal agency...." The United States asserts that the counterplaintiffs have failed to comply with this statute and, therefore, this court lacks subject matter jurisdiction. The United States observes that § 2675 provides an exception to this administrative procedure for compulsory counterclaims, but contends that this exception is inapplicable to the counterclaim filed herein because the counterclaim is permissive rather than compulsory.

With respect to the breach of contract allegations in the counterclaim, the United States alleges that there is no "privity of contract" between it and the counterplaintiffs and, as a result, sovereign immunity bars this action against the federal government. As for the counterplaintiffs' allegation

that HUD breached its duty of good faith and fair dealing, the United States responds that the counterclaim fails to state a claim under Fed. R. Civ. P. 12(b)(6) because it fails to "allege facts which if proved would constitute malice or an intent to injure."

In their response to the United States' motion to dismiss, the counterplaintiffs deny that privity of contract is lacking between the parties. The counterplaintiffs contend that the United States' sovereign immunity has been expressly waived in this bankruptcy case by 11 U.S.C. § 106(b). Lastly, the counterplaintiffs dispute the contention that the counterclaim fails to state a claim, asserting that the "counterclaim clearly and with specificity alleges that HUD tortiously acted in its dealings with the debtor...." Each of these issues will be addressed in seriatim.

II.

"When subject matter jurisdiction is challenged under Rule 12(b)(1), the plaintiff has the burden of proving jurisdiction in order to survive the motion." *Madison-Hughes v. Shalala*, 80 F.3d 1121, 1131 (6th Cir. 1996). In this instance, that means the counterplaintiffs bear this burden. As for the standard by which the court considers such a motion, the Sixth Circuit Court

of Appeals has indicated that it depends on the nature of the challenge to subject matter jurisdiction. *See United States v. Ritchie*, 15 F.3d 592, 598 (6th Cir. 1994).

> Motions to dismiss for lack of subject matter jurisdiction fall into two general categories: facial attacks and factual attacks. A facial attack is a challenge to the sufficiency of the pleading itself. On such a motion, the court must take the material allegations of the petition as true and construed in the light most favorable to the nonmoving party. *See Scheuer v. Rhodes*, 416 U.S. 232, 235-37, 94 S. Ct. 1683, 1686-87, 40 L. Ed.2d. 90 (1974). A factual attack, on the other hand, is not a challenge to the sufficiency of the pleading's allegations, but a challenge to the factual existence of subject matter jurisdiction. On such a motion, no presumptive truthfulness applies to the factual allegations, *see Ohio Nat'l Life Ins. Co. v. United States*, 922 F.2d 320, 325 (6th Cir. 1990), and the court is free to weigh the evidence and satisfy itself as to the existence of its power to hear the case. *Id.*

Id. The challenge to subject matter jurisdiction made by the United States herein is a facial attack as it is centered on the legal standing of counterplaintiffs to assert the counterclaim in this forum. Accordingly, that standard will be applied.

Likewise, in considering a Rule 12(b)(6) motion to dismiss for failure to state a claim upon which relief can be granted, the court must construe the complaint in the light most favorable to the plaintiff, accept as true the factual allegations in the complaint, and determine whether the plaintiff undoubtedly could prove no set of facts in support of

his claims that would entitle him to relief. *See, e.g., Allard v. Weitzman (In re DeLorean Motor Co.)*, 991 F.2d 1236, 1240 (6th Cir. 1993). A complaint need only give fair notice of what the plaintiff's claim is and the grounds upon which it rests. *Id.* Although this standard is extremely liberal, the plaintiff may not simply assert legal conclusions. Rather, the complaint must contain either direct or inferential allegations respecting all material elements to sustain a recovery under some viable legal theory. *Id.* Of course, the burden of demonstrating that a complaint does not state a claim is on the moving party. *See, e.g., Riumbau v. Colodner (In re Colodner)*, 147 B.R. 90, 92 (Bankr. S.D.N.Y. 1992).

III.

The court will first address the United States' argument that the counterclaim should be dismissed because of the counterplaintiffs' failure to exhaust administrative remedies with respect to their tort claim. Claims which sound in tort are actionable against the United States only under the Federal Tort Claims Act, 28 U.S.C. § 2671 *et seq*. *United States v. Green*, 33 F. Supp.2d 203, 219 (W.D.N.Y. 1998). Under this statutory scheme, a claimant must present an administrative claim to the appropriate agency, and such administrative claim

must "have been finally denied by the agency in writing" before the claimant may commence suit against the United States. *See* 28 U.S.C. § 2675(a).[2] This administrative procedure, however, specifically does not apply to claims "asserted under the Federal Rules of Civil Procedure by third party complaint, cross-claim, or counterclaim." *Id.* In order for counterclaims to fall within this exception, they must be compulsory rather than permissive. *Green*, 33 F. Supp.2d at 219. A claim is a compulsory counterclaim under Fed. R. Civ. P. 13(a) if it "arises out of the same transaction or occurrence that is the subject matter of the opposing party's claim." *Sanders v. First Nat'l Bank & Trust Co. in Great Bend*, 936 F.2d 273, 277 (6th Cir. 1990)(citing *Maddox v. Kentucky Finance Co., Inc.,* 736 F.2d

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[2]Subsection (a) of 28 U.S.C. § 2675 provides that:
An action shall not be instituted upon a claim against the United States for money damages for injury or loss of property or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, unless the claimant shall have first presented the claim to the appropriate Federal agency and his claim shall have been finally denied by the agency in writing and sent by certified or registered mail. The failure of an agency to make final disposition of a claim within six months after it is filed shall, at the option of the claimant any time thereafter, be deemed a final denial of the claim for purposes of this section. The provisions of this subsection shall not apply to such claims as may be asserted under the Federal Rules of Civil Procedure by third party complaint, cross-claim, or counterclaim.

380, 382 (6th Cir. 1984)). The Sixth Circuit Court of Appeals "applies the 'logical relationship' test for determining whether a claim arises out of the same transaction or occurrence. Under this test, [a court must] determine whether the issues of law and fact raised by the claims are largely the same and whether substantially the same evidence would support or refute both claims." *Id.* (citing *Baker v. Golden Seal Liquors, Inc.*, 417 U.S. 467, 469 n.1 (1974); *Moore v. New York Cotton Exchange,* 270 U.S. 593 (1926)).

In the present case, the counterplaintiffs argue that their counterclaim is compulsory as "The Realty Shop is a general partner of the debtor"; "[t]here are identical issues of fact and law because it concerns the pay out of monies by both the government and the debtor that were received from a loan"; "The Realty Shop would be barred in its counterclaim if [the debtor] loses its counterclaim"; and "the evidence is identical in the government's case and the counterclaim since the facts relate to the disbursement of loan proceeds and the use of the same." The United States, on the other hand, argues that no logical relationship exists between the complaint and counterclaim because "the facts, time period, relevant conduct and issues of law are all different." According to the United States, the tort claim arises out of HUD's conduct prior to closing, while

the United States' complaint arises out of unauthorized use and expenditures of assets and income in violation of the regulatory agreement.

The court agrees with the counterplaintiffs that their tort claim arises out of the same transaction or occurrence as the complaint filed by the United States. The issues of fact and law raised by the claim and counterclaim are largely the same and the same evidence would be considered because the United States challenges the defendants' withdrawals of assets and income while the counterclaim seems to indicate that these withdrawals were the result of HUD's own wrongful acts. Due to the fact that both the complaint and counterclaim arise out of the Project loan insured by HUD and the parties' conduct in connection with that loan transaction, res judicata would bar a subsequent suit on the counterclaim if the court rejected its prosecution. *Id*. ("It is well established that an opposing party's failure to plead a compulsory counterclaim forever bars that party from raising the claim in another action."). As such, the court concludes that to the extent the United States' motion to dismiss is premised on the failure to exhaust administrative remedies, the motion must be denied.

IV.

The court next turns to the question of whether sovereign immunity bars the counterclaim against the United States. This issue is easily resolved as to the debtor's ability to bring the counterclaim. Section 106(b) of the Bankruptcy Code provides that:

> A governmental unit that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose.

11 U.S.C. § 106(b).[3]

HUD has filed a proof of claim in the debtor's underlying bankruptcy case in the amount of $7,707,249.92, with the stated

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[3]This section of the Bankruptcy Code provides an additional basis for the conclusion reached in the foregoing section of this opinion that the administrative exhaustion requirement of 28 U.S.C. § 2675(a) is inapplicable to the counterclaim filed by the debtor. The Sixth Circuit Court of Appeals held in *Ashbrook v. Block* that counterclaims which fall within 11 U.S.C. § 106(b)(formerly § 106(a)) are exempt from the Federal Tort Claims Act's exhaustion requirement. *See Ashbrook v. Block*, 917 F.2d 918, 922-23 (6th Cir. 1990) (quoting *Matter of Kenny*, 75 B.R. 515, 521 (Bankr. E.D. Mich. 1987) ("The only condition imposed by section 106 is that the governmental unit file a claim. The absence of an exhaustion of remedy requirement is consistent with the reason for adoption of 106—namely to permit an estate to assert claims against a government unit as a condition for such unit's receiving distribution from the estate. It is reasonable to assume that if Congress had intended that a plaintiff, prior to instituting a tort action against a governmental unit in a bankruptcy case, exhaust his administrative remedies, it would have expressly so provided.")).

basis of the claim, in addition to money loaned, being "Project income used in violation of the HUD Regulatory Agreement and Double Damages per 12 USC 1715z-4(a)." The debtor's counterclaim against the United States is "property of the estate" because it arose prior to the debtor's bankruptcy filing. *See* 11 U.S.C. § 541. And, as this court has previously concluded, the counterclaim arose out of the same transaction or occurrence of which the government's claim arose. *See H.J. Wilson Co. v. Commissioner of Revenue (In re Service Merchandise Co.)*, 265 B.R. 917, 922-23 (M.D. Tenn. 2001) (Section 106(b)'s "same transaction or occurrence" language mirrors the compulsory counterclaim language of Fed. R. Civ. P. 13.). Accordingly, the United States is deemed to have waived sovereign immunity with respect to the debtor's counterclaim.

The issue of whether sovereign immunity precludes The Realty Shop's counterclaim is not as easily resolved. Although Rule 13(a) specifies that a party shall file a compulsory counterclaim, subsection (d) of the rule clarifies that it is not to "be construed to enlarge beyond the limits now fixed by law the right to assert counterclaims or to claim credits against the United States or an officer or agency thereof." In other words, the mere filing of a complaint by the United States does not constitute a waiver of sovereign immunity with respect

to counterclaims to that complaint. *United States v. Forma*, 42 F.3d 759, 764 (2d Cir. 1994). To the contrary, "[j]urisdictional limitations based on sovereign immunity apply equally to counterclaims against the Government." *Id.* "[J]urisdiction for a suit against the United States whether it be in the form of an original action or a set off or a counterclaim does not exist unless there is specific congressional authority for it." *Id.* Absent an express waiver of sovereign immunity, the court lacks subject matter jurisdiction. *United States v. Sherwood*, 312 U.S. 584 (1941).

In their response to the United States' motion to dismiss, the counterplaintiffs cite 11 U.S.C. § 106(b) as the statutory basis for a waiver of sovereign immunity not only with respect to the debtor's counterclaim, but also as to the counterclaim of The Realty Shop since it is the debtor's general partner. However, by its terms, § 106(b) applies only to claims against the federal government that are property of the estate. The Realty Shop's claim against HUD is not property of the debtor's bankruptcy estate and the court has been unable to find any case which has extended § 106(b)'s waiver to a claim by a partner or principal of the debtor.

The only other proffered basis for the government's consent to suit is the Tucker Act, 28 U.S.C. §§ 1346(a)(2) and 1491,

which "waives sovereign immunity as to contract claims against the United States...." *Presidential Gardens Associates v. United States ex rel. Sec. of HUD*, 175 F.3d 132, 141 (2d Cir. 1999). In order to fall within this waiver, "the contract must be between the plaintiff and the government," that is, "there must be privity of contract between the plaintiff and the United States." *Cienega Gardens v. United States*, 194 F.3d 1231, 1239 (Fed. Cir. 1998). In *Cienega Gardens*, a case which similarly involved an action by owners of low-income housing against HUD, the Federal Circuit Court of Appeals stated that "in order to find privity of contract, we must find on the part of HUD 'the type of direct, unavoidable contractual liability that is necessary to trigger a waiver of sovereign immunity, the inevitable result of finding privity of contract.'" *Id.* at 1241.

The Realty Shop asserts that there is privity of contract between it and HUD because as general partner, The Realty Shop "was required to sign the loan documents and is obligated to HUD under the regulatory agreement." The United States, however, cites *Cienega Gardens* in order to establish the absence of privity. In *Cienega Gardens*, the plaintiff-owners' lawsuit against HUD was based on the contention that HUD had breached its contract with the owners with respect to certain prepayment

terms in the loan documents. *Id.* at 1236. The government claimed there was no privity of contract because the prepayment provisions were set forth in the deed of trust note which HUD had not signed as opposed to the regulatory agreement actually signed by HUD. *Id.* The lower court disagreed, concluding that all of the loan documents at issue had to be analyzed together in determining whether privity of contract existed. *Id.* Upon appeal, the Federal Circuit reversed. Although the appellate court agreed that the deed of trust note and the regulatory agreement were part of the same transaction, the court emphasized that each document stood alone and evidenced separate agreements between distinct parties. *Id.* at 1243. Because the contractual obligations which formed the basis of the owners' lawsuit were not contained in the regulatory agreement signed by HUD and the regulatory agreement imposed no obligations on HUD, only the owners, the court found that there was no privity of contract which would trigger a waiver of sovereign immunity. *Id.*

In the present case, the counterplaintiffs allege in their counterclaim that HUD has failed to properly perform its duties under the regulatory agreement and loan documents. The United States notes, however, in its memorandum of law that the only agreement to which HUD was a party was the regulatory agreement.

The United States asserts that this regulatory agreement, like the regulatory agreement in *Cienega Gardens*, imposes obligations only upon the counterplaintiffs, not HUD, and, therefore, "counterplaintiffs have failed to demonstrate 'the type of direct, unavoidable contractual liability that is necessary to trigger a waiver of sovereign immunity' just as did the plaintiffs in *Cienega Gardens*."

An examination of the regulatory agreement, a copy of which was filed as an exhibit to the complaint, reveals that the United States is correct: the document imposes numerous responsibilities and obligations on the "Owners," but none on HUD. Absence an assumption of liability by HUD under the terms of the regulatory agreement, this court is unable to find the privity of contract sufficient to "trigger a waiver of sovereign immunity" with respect to the counterclaim by The Realty Shop.

The court does note one caveat to the conclusion that sovereign immunity bars the counterclaim by The Realty Shop. Sovereign immunity only precludes affirmative recovery against the United States on the counterclaim; it does not prohibit assertion of a counterclaim by way of recoupment in order to defeat or diminish the sovereign's recovery. *See Forma*, 42 F.3d at 764 (setting forth rule and exploring various rationales for

the exception). Accordingly, The Realty Shop may still assert its counterclaim against the United States as a defense to any recovery by the government against it under the complaint.

V.

The last issue raised by the United States in its motion to dismiss is whether the counterplaintiffs' allegation that "HUD's actions constitute ... a breach of good faith and fair dealing presumed in all contracts" states a claim upon which relief can be granted. The United States asserts that there is a presumption that government officials "act conscientiously and in good faith in the discharge of their duties," and that given this presumption, counterplaintiffs must present clear and strong proof of specific acts of bad faith demonstrating that a governmental official acted with malice or a specific intent to injure. The United States maintains that the counterclaim makes only the conclusory statement that the good faith and fair dealing duty has been breached and fails to set forth specific acts of bad faith by HUD establishing malice or intent to injure.

The United States correctly states the applicable law. As the United States Court of Federal Claims has recognized:

> [I]t is well-settled that government officials are presumed to act in good faith in the discharge of

> their duties. [Citations omitted.] Furthermore, it takes "well-nigh irrefragable proof" to the contrary to induce the court to abandon this rebuttable presumption. [Citations omitted.] In this connection, a plaintiff *must* allege and prove facts constituting malice or, in other words, a specific intent to injure the plaintiff on the part of a government official. [Citations omitted.] Moreover, the required "malice" or "specific intent to harm" may be demonstrated only by clear and strong proof of specific acts of bad faith.

Morris v. United States, 33 Fed. Cl. 733, 751-52 (Fed. Cl. 1995).

Given this standard, the court will examine the counterclaim in order to determine if the counterplaintiffs have made the required allegations of bad faith. From the court's review of the counterclaim, it appears that the only specific allegations which would evidence a lack of good faith are those which pertain to HUD's alleged failure to close the loan in question. In this regard, the counterplaintiffs allege that based on HUD's previous representations that the loan would be approved for final endorsement, "the counter plaintiffs were forced to execute agreements with Mellon Mortgage waiving certain rights which the counter plaintiffs executed under economic duress...." Yet when the parties met "for the purpose of 'closing' the loan by way of completing the documents necessary to proceed to final endorsement," HUD then "refused to proceed to final endorsement ... thereby causing the loan to go into default. HUD had no

basis for refusing to allow the loan to go to final endorsement....” The counterplaintiffs further allege that “HUD’s failure to allow the loan to close caused Mellon Mortgage to call letters of credit they were holding belonging to the counter plaintiffs which funds were received by Mellon thereby paying the loan current and in advance.”

Although the issue is a very close one, the court concludes that the counterplaintiffs have made sufficient allegations of bad faith to state a claim for breach of good faith and fair dealing. The counterplaintiffs not only assert that HUD failed to proceed to final endorsement, but that “HUD had no basis” for the failure. “[A] showing that no reasonable basis existed for the contracting officer’s decision would be indicative of arbitrariness or bad faith on his part.” *Holt v. United States*, 1980 WL 20813, *9 (Ct. Cl. Trial Div., Aug. 20, 1980). Accordingly, the court will deny the United States’ motion to dismiss for failure to state a claim.

VI.

In light of the foregoing, the court will enter an order contemporaneously with the filing of this memorandum opinion denying the United States’ motion to dismiss except with respect to the affirmative relief sought by The Realty Shop on its

counterclaim. In this regard, the motion to dismiss will be granted.

FILED: September 14, 2001

BY THE COURT

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE